

Further Fed tightening and small recession ahead limit equity upside



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IN A NUTSHELL

- 2Q would have been another sequentially flat S&P EPS quarter if not for Energy
- DWS CIO Day: Unchanged 3.50-3.75% Fed terminal rate, 4200 S&P 12-month
- Profit margins likely fall, but sales rise, we keep our 2023E S&P EPS of \$235
- High correction risk: Shelter in Health Care, Utilities, Banks and Communications

2Q would have been another sequentially flat S&P EPS quarter if not for Energy

S&P 500 quarterly earnings per share (EPS) has been flattish at \$54-55 from 3Q21-1Q22. 2Q was another sequentially flat EPS quarter with a weak macro backdrop and conservative consensus heading into earnings season. In aggregate, S&P beat on EPS by 4.3%, but only 1.2% ex. Energy. 2Q S&P EPS y/y growth was 9.7%, but down 2.2% y/y ex. Energy. The other two sectors with large EPS estimate beats were Health Care and Utilities, beating by 6.0% and 6.5% respectively. These two sectors are among our most over-weighted sectors, along with Communications and Financials. Investors feared down EPS y/y or q/q, but got mostly flat results and Energy flattered the aggregate figures. But since 2Q end, West Texas Intermediate (WTI) oil prices fell below \$90/bbl after reaching \$120/bbl in June. Our commodity team forecasts \$100/bbl oil price in 12-months, but sees lower prices near-term. Thus, Energy's boost to S&P EPS is likely to fade and we expect further bottom-up EPS cuts outside Energy. We forecast flattish 4-qtr S&P EPS ahead (\$228 w/downside risk) from trailing 4-qtr EPS (\$221). This is better than in past recessions, which on average cause 20% S&P EPS declines. This is because we see a small and short recession with still elevated inflation and resilient jobs.

DWS CIO Day: Unchanged 3.50-3.75% Fed terminal rate, 4200 S&P 12-month

The theme from our CIO day is that high inflation likely pushes most developed market (DM) economies into mild recession. US gross domestic product (GDP) contracted in 1H22 and our economists only see a 40% chance of a soft landing in the next few quarters. Inflation, especially core, remains sticky as rents and higher wages phase in. Our economists increased their US inflation outlook from 3.1% to 3.3% for 2023 and increased the inflation outlook in Europe from 3.7% to 5.0%. 2023 GDP growth is cut marginally from 0.8% to 0.7% in US and from 1.8% to 0.7% in Europe.

We expect the Fed to remain in inflation fighting mode and to not stop hiking the Fed Funds rate until it reaches at least 3.50%-3.75% by 2022 end (additional early 2023 hikes possible). We expect no more hikes in 2023, but also no cuts through September 2023. With this Fed road map in mind, we keep our 10yr Treasury yield forecast at 3.25%; this includes an expectation of a roughly 2.75% 10yr breakeven inflation rate and 0.50% 10yr Treasury Inflation-Protected Securities (TIPS) yield.

We expect war in Ukraine to continue, but oil prices are unlikely to surge again given rising supply from Organization of the Petroleum Exporting Countries (OPEC) (perhaps Iran sanctions lift) and Russian oil finding its way to Asia along with a strong dollar and demand dented from economic slowing and high oil prices. DWS lowered oil targets, but we raised Energy profits on profit beats in 2Q relative to oil prices.

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DWS September end 2023 S&P 500 target is 4200 with little return potential from current levels. Near-term, we see downside risk for the S&P 500 as it would be quite uncommon for the market to find its bottom while the Fed is still hiking and EPS growth is stalled. While Fed hikes likely end within 12-months, we might be in a multiyear period of low real returns.

Profit margins likely fall, but sales rise, we keep our 2023E S&P EPS of \$235

We are still worried about unrealistically high S&P EPS expectations for 2023. Corporate margins are likely to suffer, at least a little, not only because they are at record highs now with immediate cyclical risks, but also because of wage, tax, regulation pressures ahead and lingering input cost pressures. While cyclical sectors are obviously most at risk, IT-spending on semiconductors, hardware and perhaps even software likely take hits. The extraordinary USD-strength will add additional earnings pressure to US multinationals, with the negative currency impact doubling from Q1 to Q2. Our foreign exchange (FX) strategists see sustained strength in the dollar and lower EUR/USD 12-month target from 1.10 to 1.05. We keep our 2023E S&P EPS at \$235, but we added \$5 worth of S&P EPS to 2023E Energy earnings.

High correction risk: Shelter in Health Care, Utilities, Banks and Communications

We think this summer's equity rally from its June low has gone too far and is too early. We see high risk of a 10%+ decline from S&P 4300 given deteriorating macro and earnings rest of this year into next. Just because the S&P suffered a 23% decline in the first half, doesn't make it less likely to suffer a 10%+ decline from recent highs. History shows that corrections tend to come in pairs or bunches with a few within a couple of years and then none for several years. However, we don't think the 3666 low in June will be revisited if no new shocks. We prefer Health Care with its profits supported by innovation in medicine and medical devices. Utilities are an attractive bond substitute with non-cyclical and inflation protected dividend yields. We like Banks as we don't expect a surge in credit costs. We like Communications given its role in digitalization and virtualization and that valuations acknowledge pricing and investment pressures from competition and disruption risks.

Glossary

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

FX is the abbreviation for **foreign exchange**, i.e. currencies.

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The **Organization of the Petroleum Exporting Countries (OPEC)** is an international organization with the mandate to "coordinate and unify the petroleum policies" of its meanwhile 12 members.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

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